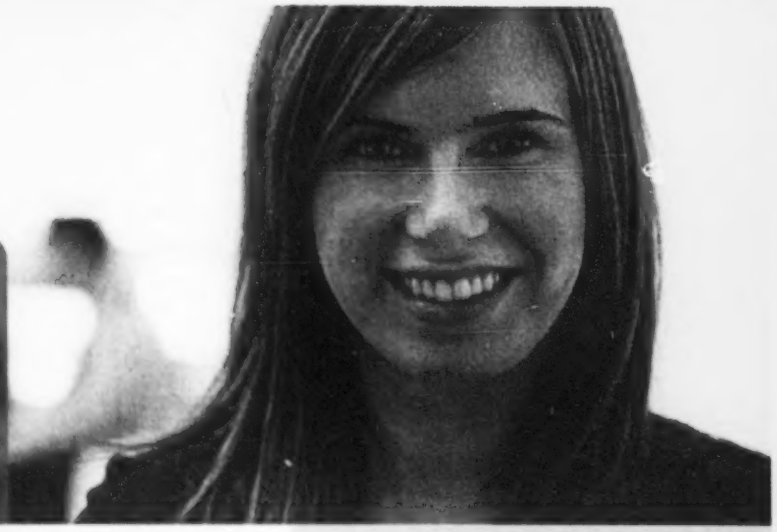
BDC
Entrepreneurs first

economic LETTER

FEBRUARY 2011



INTERIM RATES AND HOUSEHOLD DEBT: THE DILEMMA FACING THE BANK OF CANADA

In the last few months the Bank of Canada has made it clear that it is concerned about rising levels of household debt, which hit an unprecedented high of 148% of disposable income in the third quarter of 2010. Household debt as a percentage of household net worth – which may be a more accurate measure of the financial position since it takes wealth into account – also hit a record high (see graph). The reason why households borrowed so much in recent years is largely because interest rates were very low. So why is the Bank of Canada not raising interest rates if it is so concerned about household debt?

The Bank of Canada's main objective is to control inflation. When economic growth is weak and inflation is likely to stay below its target of 2%, the central bank keeps interest rates low to encourage spending and investment. This leads to an increase in household debt. That would not be a problem if only those households with the means to borrow took advantage of low interest rates, but such is obviously not the case. According to the Bank of Canada, Canadian households in general are increasingly vulnerable to adverse shocks such as an increase in interest rates or unemployment. Obviously, interest rates will not always be as low as they are now: we have to expect them to rise to more normal levels sooner or later.

So what can be done to rein in debt? A first step is the awareness campaign launched by the central bank, which has voiced its concerns over and over again in official speeches and public statements by the Governor and other senior executives. By warning of the risks of an eventual rise in interest rates, the Bank is reminding households that they should make sure they will be able to repay in the future the debt they take on today, and reminding financial institutions that they should make sure their clients can service their debt.

There are also ways to tackle the root of the problem, by restricting access to credit by more vulnerable households. This is what the government has done by adopting a series of more restrictive measures to be applied in 2011. For example, the Canada Mortgage and Housing Corporation will no longer insure mortgages with an amortization period of 35 years: in future the maximum will be 30 years. Also, the amount that can be borrowed when refinancing a mortgage ▼

Canada

> **Real GDP growing**

> **Job market expanding**

> **Housing starts down**

> **Trade deficit disappears**

> **Consumer spending remains strong**

United States

> **Real GDP growth accelerating**

> **Employment growing but at a snail's pace**

> **Housing sector recovering very slowly**

Interest rates

Gap between Canadian and U.S. key interest rates should remain stable in the short term.

Oil and dollar

SME confidence

Credit conditions

Key indicators

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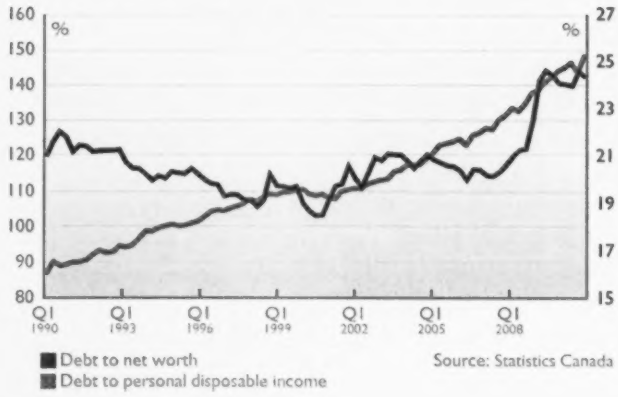
will go down from 90% to 85% of the value of the home. Lastly, the government will no longer insure lines of credit that use a home as collateral, such as home equity lines of credit. These measures will force financial institutions to take on more credit risk and should make them more cautious when lending to households.

We will have to wait and see whether these measures are effective or whether credit will have to be tightened even more. One thing we do know is that, as the Canadian economy regains strength, the Bank of Canada will have to raise interest rates to control inflation, which will naturally curtail household debt. ■

Household debt ratios



CANADA

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According to the latest data, the Canadian economy is doing well. Real GDP is continuing to grow. The labour market has recovered all of the jobs lost during the recession and is now expanding. Consumer spending remains strong and business confidence is on the rise. Housing starts are down but the experts, who had predicted this, think the decline should be limited. Forecasters' average prediction for economic growth in 2011 is 2.5% compared to 2.9% in 2010.

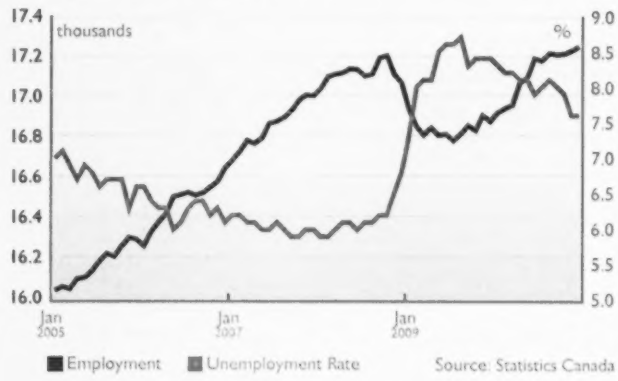
GDP continues to grow

Real GDP grew 0.4% in November compared to October. The main sector behind this growth was oil and gas extraction. Numbers were also up in the wholesale and retail, real estate, and finance and insurance sectors, while they were down in construction and manufacturing. In the latter case, the automobile and auto parts industry accounted for much of the decline, due to temporary closures of assembly plants for retooling and a reduction in the number of shifts in parts manufacturing.

Job market expanding again

In December 22,000 jobs were created but unemployment remained unchanged at 7.6%. Between December 2009 and December 2010 employment grew 2.2% following a decline of 1.1% in the previous 12 months. The labour market has now recovered all of the jobs lost during the recession and even added some. In December 38,000 full-time jobs were created while 16,000 part-time jobs disappeared. After losing 29,000 jobs in November, the manufacturing sector added 66,000 jobs in December. Between December 2009 and December 2010 employment in this sector grew 1.8%.

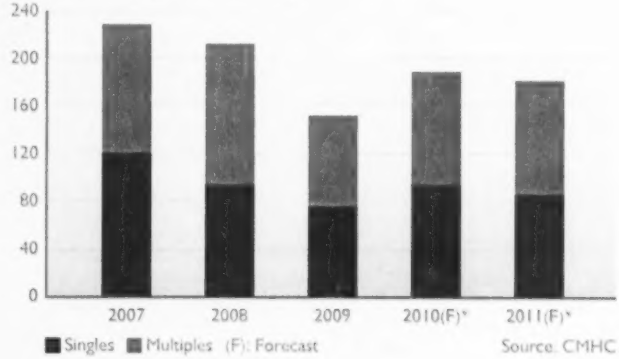
Employment and Unemployment Rate



Housing starts and sales of existing homes down

Housing starts rose to 171,500 units in December, down from 198,200 in November. Multiple housing starts dropped 20.1% in urban centres but the decline in single family homes was only 2.6%. Although sales of existing homes were down ▼

Canada Starts (in thousands)

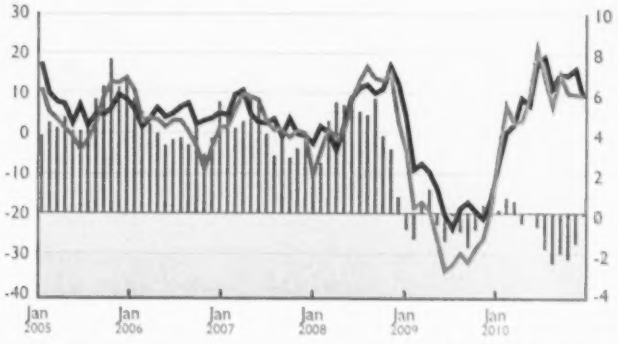


slightly in December from the previous month, they were higher in the fourth quarter than the third. The Canadian Real Estate Association thinks that low interest rates will continue to buoy the housing market in 2011. However, according to Canada Mortgage and Housing Corporation, the number of starts should decline from an average of 186,200 in 2010 to 174,800 in 2011, a level that CMHC thinks is more in line with changes in demographic fundamentals.

International trade returns to a balanced situation

Canada's international trade deficit literally melted away, from $1.5 billion in October to only $85 million in November, due to a substantial drop in imports (-3.2%), especially in the energy sector. Imports of machinery and equipment also fell after expanding for nine consecutive months. Exports were up 0.8 % in value ajout suggéré but down 2.0% in volume, with the volume of automotive products declining 10.0% due to temporary closures of some plants in November.

Canada International Trade



Source: Statistics Canada

Consumer spending remains strong

Retail sales continued to trend upwards, growing by 1.3% in both value and volume in November. This was their strongest monthly increase since March 2010. Eight of the eleven sectors (representing 90% of total sales) posted gains. The largest was in sales of motor vehicles and parts. Sales of apparel and apparel accessories rose 2.8% in November, which brought their annual growth to just above 10%. This was the next best annual result after service station sales, which jumped 13.8% between November 2009 and November 2010. ■

★ UNITED STATES

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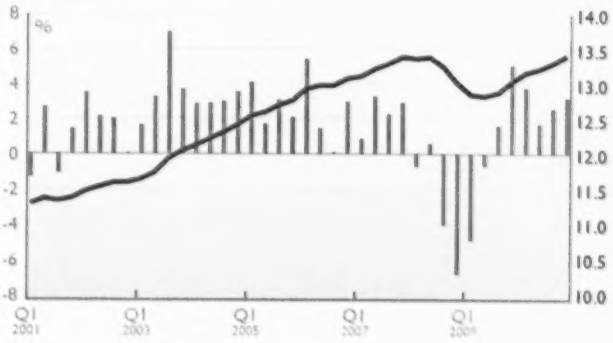
Growth accelerated in the last quarter of 2010. After recovering all of the production lost during the recession, the United States is now embarking on a new expansion phase. However, job creation is anemic and, despite some improvement, the housing market is still depressed. Forecasters are predicting real GDP growth of 3.2% in 2011, which is well below the growth rates observed after previous recessions.

Production lost during the recession has now been recovered

According to initial estimates, real GDP growth accelerated in the fourth quarter of 2010, with a quarter-over-quarter variation from 2.6% in the third quarter to 3.2% in the fourth. The production lost during the recession has now been recovered and the United States will be embarking on a new expansion phase. The acceleration in real GDP growth in the fourth quarter mainly reflects growth in consumer spending and net exports and a turnaround in residential investment, which went from -27.3% in the third quarter to 3.4% in the fourth. Even if the recovery is now complete, a significant improvement in the job market and housing sector will be needed before the U.S. economy starts to grow strongly again. For the moment, the Consensus is forecasting 3.2% growth in 2011. ▼

U.S. Real GDP



Source: U.S. Bureau of Economic Analysis

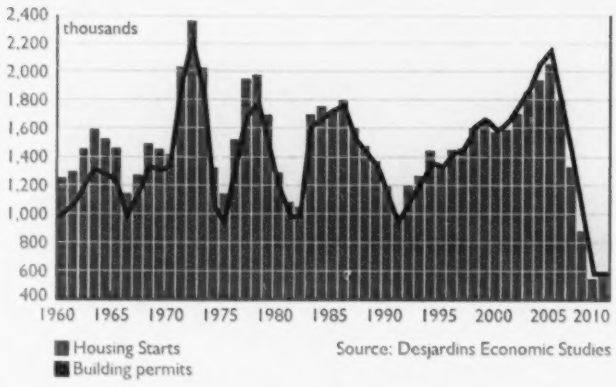
Employment growing but at a snail's pace

The non-agricultural sector added 103,000 jobs in December and the unemployment rate edged down by 0.4 percentage points to 9.4%. Between December 2009 and December 2010 the non-agricultural sector grew by only 0.9%–or 1.3% if only private sector jobs are considered–which is minimal. As long as job creation remains weak, the economic recovery will continue to be fragile and fraught with uncertainty.

Housing market recovering very slowly

Housing starts were down 4.3% in December compared to November. However, in 2010 starts recorded their first annual increase since 2005, coming in at 6.1% higher than in 2009. With an average of 587,600 units in the year, the level is still extremely low historically, as shown in the graph below. On the other hand, the number of building permits jumped 16.7% in December, which points to an increase in housing starts in the coming months. For existing home sales, growth in December was strong at 12.3%. Despite this increase, sales were 2.9% lower than in December 2009 and the inventory of homes for sale remained high, at 8.1 months. The housing market should improve as the job market improves, but the recovery will be slow. ■

Housing Starts



INTEREST RATES

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No change in Canadian and U.S. key interest rates expected in the short term

On January 18 the Bank of Canada decided to leave its key interest rate unchanged at 1.0%. On January 26 the U.S. Federal Reserve also opted for the status quo. As a result, the gap between Canadian and U.S. key interest rates remained the same. The forecasters say it should stay the same at least until the end of the second quarter of 2011, after which they expect the Bank of Canada to start raising its rate. The U.S. key interest rate, however, is not expected to rise before the end of 2011. Monetary authorities will need to see an improvement in the job market before raising the rate. ■

OIL AND THE LOONIE

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Price of oil and Canadian dollar both up

The price of crude rose during the month because of uncertainty about the situation in Egypt. Although Egypt is not a big producer, two crude oil shipping routes run through it: the Suez Canal and the Suez-Mediterranean pipeline. The Canadian dollar was driven up by rising oil prices. Changes in the price of oil–and the Canadian dollar–in the future will depend on various factors, including the possible spread of the demonstrations in Egypt to other countries, which could disrupt crude oil supplies and cause sudden price fluctuations. ■

Crude Oil Price and Canada - U.S. Exchange Rate

SME CONFIDENCE

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Small business leaders still confident

> The CFIB Business Barometer Index, which had rebounded in December, barely budged in January, indicating that the renewed confidence shown by small business leaders at the end of 2010 carried over into 2011.

> Seven of the thirteen sectors had index levels above 70 – a robust result. The finance, insurance and real estate sector led the way, followed by the natural resources sector. In the hospitality sector, which is the only one with an index below 60, entrepreneurs remain pessimistic.

> Businesses in western Canada are still more upbeat than those in central and eastern Canada, with the exception of Newfoundland and Labrador. However, the climate has improved significantly in Quebec, where the index gained nearly 10 points since November.

> The average price increase planned for the business' own products over the next 12 months is 1.7% – the highest in more than two years. At the same time, many companies say they are concerned about rising fuel and energy costs. ■

BUSINESS CREDIT CONDITIONS

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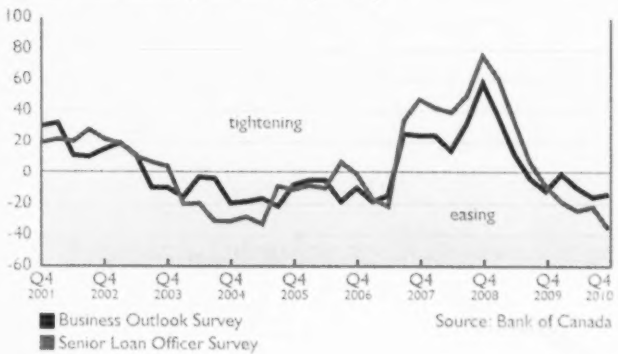
Business credit continues to recover slowly as credit conditions ease

Business credit from chartered banks continued to rise, but in December was still 3.9% lower than it had been 12 months earlier. The results of the Bank of Canada's Senior Loan Officer Survey (SLOS) and Business Outlook Survey (BOS) indicate that credit conditions continued to ease in the fourth quarter of 2010. According to the BOS, it was mainly mid-sized and large businesses that benefited from the easing of credit conditions. ■

Credit Conditions (balance of opinion)



Source: Bank of Canada

KEY INDICATORS – CANADA

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Key indicators – Canada	Historical				2010				Latest		Forecast	
	2007	2008	2009	2010	Q1	Q2	Q3	Q4			2011	2012
Real GDP (% growth)	2.2	0.5	-2.5	2.9e	5.6	2.3	1.0		Nov	0.4	2.5	2.7
Machinery and Equipment Expenditures (% growth)	4.2	-0.9	-20.3	13.7e	17.8	32.7	28.7				14.3	8.2
Pre-Tax Corporate Profits (% growth)	1.9	8.0	-32.3	16.9e	31.9	-2.4	2.8				10.8	9.5
Industrial Production (% growth)	-0.5	-4.5	-9.4	5.3e	11.1	9.3	2.0		Nov	0.2	4.1	4.2
Industrial Product Prices (% growth)	1.5	4.3	-3.5	0.7e	3.6	1.2	-1.0	6.3	Dec	0.7	2.3	2.7
Non-Residential Construction (% growth)	2.3	7.7	-19.5		5.4	0.9	10.9					
Housing Starts (000 units)	228	213	148	191e	198	198	192	179	Dec	168	173	178
Personal Expenditures (% growth)	4.6	2.9	0.4	3.4e	4.1	2.3	3.5				2.7	2.6
Consumer Price (% growth)	2.1	2.4	0.3	1.8	2.3	-0.9	2.4	4.8	Dec		2.2	2.1
Employment (% growth)	2.4	1.7	-1.6	1.4	1.5	3.4	1.4	0.4	Dec	0.2		
Unemployment Rate (%)	6.0	6.1	8.3	8.0	8.2	8.0	8.0	7.7	Dec	7.6	7.6	7.3
SMEs Confidence Index (CFIB)	67.2	56.1	57.7	66.7	68.4	66.7	64.7	66.7	Jan	68.9		
Manufacturers Confidence Index (CFIB)	64.5	52.7	56.0	68.6	69.7	69.0	65.7	70.2	Jan	70.7		

Sources: Statistics Canada, Consensus Economics and Canadian Federation of Independent Business. Annual growth and quarterly growth at annual rate. e=estimation.